

# Apportionment of Corporate Income to the States for Tax Purposes: Fifty Ways to Lose Your Tax Dollar

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## Repository Citation

Thomas J. Nichols, *Apportionment of Corporate Income to the States for Tax Purposes: Fifty Ways to Lose Your Tax Dollar*, 61 Marq. L. Rev. 480 (1978).

Available at: <http://scholarship.law.marquette.edu/mulr/vol61/iss3/7>

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## APPORTIONMENT OF CORPORATE INCOME TO THE STATES FOR TAX PURPOSES: FIFTY WAYS TO LOSE YOUR TAX DOLLAR

At issue in the recent case of *Moorman Manufacturing Co. v. Bair*<sup>1</sup> was the constitutionality of Iowa's system for determining what portion of the income of interstate manufacturing corporations should be assigned to that state for tax purposes. The Iowa statute apportioned such corporate net income on the basis of the ratio of the amount of sales made to destinations within Iowa to the total amount of sales made by the corporation.<sup>2</sup> The Iowa Supreme Court in the *Moorman* case upheld the statute in the face of attacks upon it as being violative of the due process and equal protection clauses of the United States and Iowa Constitutions and the commerce clause of the United States Constitution. However, the issue may not yet be resolved as the United States Supreme Court has recently noted probable jurisdiction to hear the case.

Apportionment is an important issue in interstate commerce. In 1972, the latest year for which such statistics are available, over 95 billion dollars of corporate net income was subject to state taxation. Almost two-thirds of this amount, more than 62 billion dollars, was derived from manufacturing and mercantile operations.<sup>3</sup> Statistics also indicate that manufacturing and mercantile concerns are quite likely to carry on business across state lines and, consequently, have to divide their income among several states for income tax purposes.<sup>4</sup> Regardless of the nature of the business, every corporation which operates in two or more states must deal with the prospect of paying income taxes in more than one state and dividing its income accordingly.

Formula apportionment is the principal method used for

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1. 254 N.W.2d 737 (Iowa 1977), *prob. juris. noted*, 98 S. Ct. 478, No. 77-454 (Nov. 14, 1977).

2. IOWA CODE § 422.33 (1975).

3. I.R.S., STATISTICS OF INCOME—1972 CORPORATE INCOME TAX RETURNS, Table 1 (1976). Although these statistics are based upon figures for taxable net income appearing on federal tax returns, most states use essentially the same figure for their own tax purposes. See text accompanying notes 25-26, *infra*. Therefore, these statistics are equally applicable to state income taxes.

4. See SPECIAL SUBCOMM. ON STATE TAXATION OF INTERSTATE COMMERCE OF THE HOUSE COMM. ON THE JUDICIARY, STATE TAXATION OF INTERSTATE COMMERCE, H.R. REP. NO. 1480, 88th Cong., 2d Sess. 88 (1964) [hereinafter cited as REP. 1480].

effectuating this division of income.<sup>5</sup> Although Iowa's formula is the only one which apportions income entirely upon the basis of sales,<sup>6</sup> all but three of the forty-six jurisdictions in the United States which impose a corporate income tax include a sales factor in their apportionment formulas.<sup>7</sup> Thus, the final decision on the validity of Iowa's single-factor sales apportionment system is likely to have significant repercussions in the entire area of state corporate income taxation.

## I. THE *Moorman* CASE

### A. *Moorman Manufacturing Company*

Moorman Manufacturing Company is typical of the type of interstate corporation whose income is subject to apportionment. Its principal source of income for the years in question was the manufacture and sale of some eighty different products for feeding livestock and poultry. Moorman, an Illinois corporation, did all of its manufacturing in the states of Illinois, Texas and Nebraska. Its products were sold in more than thirty states. One of those states was Iowa, where Moorman operated six warehouses and maintained a force of over 500 employees who engaged in "continuous solicitation of Iowa customers."<sup>8</sup>

Manufacturing all of its products in only three states and selling these products primarily to customers outside of the state of manufacture, Moorman Manufacturing is considered a "unitary business." A business is said to be "unitary" when "the operation of the portion of the business within the state is dependent upon or contributory to the operation of the business outside the state."<sup>9</sup> Because of the nature of a unitary business, it is impossible to determine precisely where the profits of such a business arise. Consequently, a corporation engaged in a unitary business must resort to the somewhat arbi-

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5. *Id.* at 113.

6. Missouri allows the taxpayer the option of apportioning income upon the basis of sales alone. Mo. REV. STAT. § 143.51 (Supp. 1975).

7. In the large majority of these forty-three jurisdictions, the formulas consist of three equally-weighted factors: property, payroll and sales. Arizona and Mississippi have no statutorily-prescribed apportionment formula, though both states appear to recognize apportionment as one method of dividing income for tax purposes. West Virginia's formula contains only the two factors of property and payroll. [1977] STATE TAX GUIDE (CCH) ¶¶ 10,203 - 10,943.

8. 254 N.W.2d at 738-39.

9. G. ALTMAN & F. KEESLING, ALLOCATION OF INCOME IN STATE TAXATION 101 (2d ed. 1950).

trary method of apportionment to divide its income among the states in which it operates so that each state will tax only those profits earned within its borders. Typical of this type of business is the manufacturing concern such as Moorman and, to a lesser extent, the mercantile business, consisting of the purchase of goods in one state for sale in another state.<sup>10</sup>

Apportionment is a method of dividing income by multiplying the corporation's income by a ratio. That ratio is the amount of a certain aspect of the corporation's business located within the state divided by the total amount of that aspect for the corporation as a whole. Thus, Iowa's method, based entirely upon sales, operates by multiplying the corporation's income by the ratio of the amount of corporate sales within Iowa to the total amount of corporate sales. It is upon this resulting figure that the Iowa corporate income tax is levied. In the majority of states a three factor system is used. The corporation's net income is multiplied by the arithmetic average of three ratios: corporate property within the taxing state to total corporate property, corporate payroll within the state to total payroll and corporate sales within the state to total sales.<sup>11</sup>

Business concerns in a number of industries are usually considered "nonunitary."<sup>12</sup> The operation by one firm of a dairy farm in Wisconsin and a haberdashery in Brooklyn would generally not be treated as a single unitary business. Since, by definition, the nonunitary business of a firm in one state is not dependent upon the firm's operations elsewhere, it is at least theoretically possible to determine which of the firm's gross

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10. See Rudolph, *State Taxation of Interstate Business: The Unitary Business Concept and Affiliated Corporate Groups*, 25 TAX L. REV. 171, 194 (1970) [hereinafter cited as Rudolph]; Hellerstein, *Recent Developments in State Tax Apportionment and the Circumscription of Unitary Business*, 21 NAT'L TAX J. 487, 496, 501-03 (1968) [hereinafter cited as Hellerstein, *Unitary Business*].

11. An example will serve to illustrate both how the system operates and how the choice of apportionment formula affects the total amount of income which is taxable in the state of sale for a firm such as Moorman. If a corporation's net income were \$100 and the total amounts of its property, payroll and sales were \$100 each and the amounts of each of those factors located within the taxing state were 5, 15 and 20 respectively, the amount of income taxable under the Iowa system would be  $20/100 \times \$100$ , or \$20. Under the three factor system  $(5/100 + 15/100 + 20/100)/3 \times \$100$ , or only \$13, would be taxable.

12. Mining, banking, farming and hotel operations have been mentioned as examples of businesses which can be operated so as not to be unitary despite the fact that the same corporation carries on the same business in several states. Hellerstein, *Unitary Business*, *supra* note 10, at 496-97.

receipts and expenses should be assigned to that state. The net income taxable in that state can then be determined without resorting to apportionment. This process of separate accounting is the only method, other than apportionment, which is used to any significant degree by corporations to divide their ordinary business income among the various states for tax purposes.<sup>13</sup> Often it is the only alternative offered to replace formula apportionment.<sup>14</sup>

The separate accounting method has serious drawbacks as an alternative to apportionment in the case of manufacturing corporations such as Moorman. Maintaining books of account which break down all of the manufacturer's operations on a state-by-state basis is quite expensive. Furthermore, in order to keep a different set of books for both the state of manufacture and the state of sale, it is necessary to devise an "imputed price" at which the manufacturing operation "sells" the product to the sales operation.<sup>15</sup> However, this "imputed price" is, of necessity, an accountant's construct. Regardless of whether the figure is intended to equal the price at which such goods would be available in the open market or is simply based upon a cost plus reasonable profit formula, the statistics upon which to base such estimates are in many cases "simply nonexistent."<sup>16</sup>

Besides these practical drawbacks, the practice of separate accounting may also suffer from a theoretical defect which could make it an inappropriate tool for division of income, not only for manufacturing concerns such as Moorman, but also for highly diversified conglomerates as well. The idea that a corporation may sustain losses in some parts of its business, while

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13. The oil and gas industry has been called a "stronghold for separate accounting." Rudolph, *supra* note 10, at 187. *But see* Amoco Products Co. v. Arnold, 213 Kan. 636, 518 P.2d 453 (1974); Honolulu Oil Corp. v. Franchise Tax Bd., 60 Cal. 2d 417, 386 P.2d 40, 34 Cal. Rptr. 552 (1963).

14. See Hellerstein, *The Unitary Business Principle and Multicorporate Enterprises: An Examination of the Major Controversies*, 27 TAX EXECUTIVE 313, 315 (1975) [hereinafter cited as Hellerstein, *Major Controversies*].

15. The net income attributable to the manufacturing state would be this imputed "sales price" minus the costs of manufacturing; the net income attributable to the sales operations would be the actual sales price minus the "sales price" it "paid" for the goods.

16. "Where will you find independents who will sell automobiles to manufacturers or wholesalers in the quantities, product breakdown, delivery dates, credit and other terms at which General Motors delivers to its sales divisions?" Hellerstein, *Major Controversies*, *supra* note 14, at 316. See also REP. 1480, *supra* note 4, at 163-67.

realizing profits in others, has been criticized as "both archaic and myopic."<sup>17</sup> The example is given of an oil company that drills nine wells in nine states, eight of which prove unproductive and one of which is successful enough to offset the losses in the other states. Perhaps it is better to treat the entire operation as a moderate success, rather than to recognize losses in eight states and a huge profit in the ninth. The latter would be the result under separate accounting.<sup>18</sup> One of the reasons given for the success of conglomerates is the ability of such an operation to spread the risks of highly diverse lines of manufacture so as to be able to absorb losses in one area without bankrupting the entire operation.<sup>19</sup> Here again, separate accounting does not recognize this interdependence.

It is because of the practical problems involved with separate accounting and the consequent difficulty in administering a corporate income tax system which uses it as a method of income division that state tax administrators prefer use of the more easily applied formula apportionment system.<sup>20</sup> Many courts place a heavy burden upon the proponent of separate accounting, regardless of whether it is the tax administrator or the taxpayer that is attempting to deviate from statutory apportionment.<sup>21</sup> As a result, separate accounting, though not entirely obsolete, is clearly on the wane as a method of dividing income for purposes of state corporate income taxation.<sup>22</sup> While

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17. Keesling and Warren, *California's Uniform Division of Income for Tax Purposes Act*, 15 U.C.L.A. L. REV. 156, 172 (1967) [hereinafter cited as Keesling and Warren].

18. *Id.* at 173-74.

19. *Id.* at 172 n.47. See also Hellerstein, *Major Controversies*, *supra* note 14, at 317.

20. Goldstein, *Allocation of Income for Purposes of Corporate Taxation*, 1 TAX L. REV. 149, 150-51 (1946).

21. See PETERS, STATE INCOME TAX PROBLEMS OF INTERSTATE BUSINESS, 1 PROCEEDINGS OF THE THIRTY-THIRD ANNUAL INSTITUTE ON FEDERAL TAXATION 899, 950-56 (New York University 1975) [hereinafter cited as PETERS], and cases cited therein.

22. See Rudolph, *supra* note 10, at 191. While separate accounting began as the preferred method of division of income, a shift toward apportionment soon occurred so that by 1929 six of the sixteen corporate income tax jurisdictions did not allow separate accounting and in 1963 only five of the thirty-eight such jurisdictions indicated a preference for it. REP. 1480, *supra* note 4, at 115. Despite the fact that eight more states have adopted a corporate income tax since then, only three states, Arizona, Hawaii and Mississippi, indicate any preference for separate accounting today. See [1977] STATE TAX GUIDE (CCH) ¶¶ 10,203 - 10,943. *But cf.* Rudolph, *supra* note 10, at 192; Hellerstein, *Unitary Business*, *supra* note 10, at 503 (indicating that the Supreme Court may in the future circumscribe the doctrine of "unitary business" and begin to require separate accounting in certain instances).

there has been a trend away from its use by manufacturing and mercantile concerns for quite some time,<sup>23</sup> as separate accounting is used less by the other types of businesses, formulary apportionment and the *Moorman* case assume an even greater importance.<sup>24</sup>

### B. *Analysis of the Iowa Apportionment System*

In many respects, the Iowa apportionment system is quite typical of the income division methods used in the several states. Except for adjustments made to allow for exempt income, changes in basis and federal income taxes, taxable "net income" under the Iowa system is the same as that computed for federal tax purposes.<sup>25</sup> Most of the states follow this practice of essentially adopting the federal definition of taxable "net income." For the most part, states use the taxable income figure from the federal return, requiring only minor adjustments which involve simple addition or subtraction of amounts which are readily available from either the federal return or other reasonably convenient sources.<sup>26</sup>

The tax rate applied to corporate net income attributable to Iowa is graduated with all income over \$100,000 being taxed at a rate of ten percent.<sup>27</sup> If the trade or business of a corporation is "carried on entirely within the state," the graduated rate is applied to its entire net income. If that trade or business is "carried on partly within and partly without the state," the income tax is imposed "only on the portion of the net income reasonably attributable to the trade or business within the state."<sup>28</sup>

The method for determining the portion of income "reasonably attributable" to instate operations is a statutorily prescribed two-step process. The first step involves allocation of interest, dividends, rents, and royalties (less related expen-

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23. See REP. 1480, *supra* note 4, at 162.

24. Two bills before Congress at the present time would prescribe an apportionment formula for the states. The result reached by use of the federal formula would constitute a maximum amount of income which a state could attribute to itself for income tax purposes. No provision is made for separate accounting. See S. 2173, 95th Cong., 1st Sess. (1977); H.R. 669, 95th Cong., 1st Sess. (1977). See also text accompanying notes 192-201, *infra*.

25. IOWA CODE § 422.35 (1975).

26. See REP. 1480, *supra* note 4, at 279.

27. IOWA CODE § 422.33 (1975).

28. *Id.* § 422.33(1).

ses) either to the state of Iowa or to another state, depending upon the location of the income-producing activity.<sup>29</sup> Unlike apportionment, which divides income among the several states with which it was associated, this process of allocation segregates particular portions of income. Each portion, in its entirety, is either included in or excluded from taxable net income. Most of the other corporate income tax states follow this practice of specifically allocating certain types of nonbusiness income before applying the apportionment fraction. Several states have adopted, in whole or in part, the Uniform Division of Income for Tax Purposes Act (UDITPA),<sup>30</sup> which specifically allocates rents and royalties from tangible property, capital gains, interest, dividends and patent or copyright royalties to the extent that they constitute "nonbusiness income."<sup>31</sup> The UDITPA defines "nonbusiness income" as income not "arising from transactions and activity in the regular course of the taxpayer's trade or business."<sup>32</sup>

Despite this apparent uniformity, the treatment of nonbusiness income has been characterized as "[o]ne of the more glaring nonuniform aspects" of interstate taxation.<sup>33</sup> States vary on the types of income required to be specifically allocated<sup>34</sup> and the state to which such segregated income is to be attributed.<sup>35</sup> Differences exist even among states which have adopted the UDITPA.<sup>36</sup> It is conceivable that one state might

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29. *Id.* § 422.33(1)(a).

30. As of this writing, twenty-six of the forty-six jurisdictions (including forty-five states and the District of Columbia) which impose a corporate income tax have adopted the UDITPA. Two more have adopted the Multistate Tax Compact, which includes the UDITPA in its provisions. [1977] STATE TAX GUIDE (CCH), at 1042-44. For a discussion of important deviations from the provisions of the UDITPA among these states, see notes 203-04, *infra*.

31. UDITPA § 4.

32. UDITPA § 1(a).

33. Nemeth and Agee, *State Taxation of Multistate Business: Resolution or Stalemate?*, 48 TAXES 237, 249 (1970) [hereinafter cited as Nemeth and Agee].

34. See REP. 1480, *supra* note 4, at 198-200. For example, whereas Iowa specifically allocates only interest, dividends, rents and royalties, the UDITPA applies the method to all "nonbusiness" capital gains also.

35. *Id.* at 200-15. Whereas some states, such as Iowa, allocate nonbusiness income to the location of the income-producing activity, the UDITPA allocates such income to various places, including the taxpayer's commercial domicile and the location of the property, as well as the location of the income-producing activity, depending upon the specific type of income involved. UDITPA §§ 5-8.

36. One of the "major differences" among the varying sets of regulations adopted to supplement the UDITPA in the states which have adopted the Act is in provisions classifying particular types of income as either "business" or "nonbusiness." Peters,



allocate "nonbusiness" income to itself and another state might either allocate that same income to itself or consider it to be "business" income and apportion a fraction of the income to itself. Therefore, this lack of uniformity can result in certain corporate income being taxed by more than one state.<sup>37</sup>

It is more likely, however, that the business/nonbusiness distinction results in undertaxation so that less than 100 percent of a corporation's available income is taxed. Because the facts upon which the distinction rests are within the corporation's exclusive control, a taxpayer may take advantage of this loophole by shuffling the same income from the "business" to the "nonbusiness" category and back again to avoid being taxed on its entire income.<sup>38</sup>

This tactic may well be responsible for the declining support for the business/nonbusiness distinction among state tax administrators and its characterization as one of the "least satisfactory aspects of UDITPA."<sup>39</sup> Even in those states which retain the distinction, there is a strong bias among administrators toward apportioning all net income, without first allocating any portion of it.<sup>40</sup> Many business tax practitioners also consider the distinction unworkable and believe that it should be abandoned in favor of apportionment of all corporate net

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*An Analysis of Important Recent Developments in the State and Local Tax Area*, 39 J. TAX. 172, 176 (1973). Difficult disputes arise under the UDITPA as to whether particular types of transactions, such as the sale of tangible property used in trade or business, constitute "business" or "nonbusiness" activities. See Keesling and Warren, *supra* note 17, at 164. Disputes also arise as to the state to which particular types of "nonbusiness" activities should be attributed. See, e.g., *id.* at 165-67 (arguing that the UDITPA attribution provisions should have been modified in California to conform to the state's previous practice).

37. *Developments in the Law, Federal Limitations on State Taxation of Interstate Business*, 75 HARV. L. REV. 953, 1011 (1962) [hereinafter cited as *Developments in the Law*].

38. For example, if 50% of a corporate taxpayer's income is from intangibles which would be allocable to state A and its apportionment fraction is 60% in state A and 40% in state B, the corporation might be able to treat its entire income as apportionable business income in state A, thereby being taxed on 60% in state A, while at the same time treating the 50% intangibles income as nonbusiness in state B, thereby incurring a tax on only 40% of the remaining 50% of its income, or 20%, in state B. The result is that only 80% of the corporate income is taxed, 60% in state A and 20% in state B. Corrigan, *Interstate Corporate Income Tax—Recent Revolutions and a Modern Response*, 29 VAND. L. REV. 423, 424-25 (1976) [hereinafter cited as Corrigan].

39. GLAZER, PROPOSED SOLUTIONS TO AREAS OF CONFLICT IN TAXATION OF INTERSTATE BUSINESS, PROCEEDINGS OF THE THIRTY-THIRD ANNUAL INSTITUTE ON FEDERAL TAXATION 983, 992 (New York University 1975) [hereinafter cited as GLAZER].

40. PETERS, *supra* note 21, at 916.

income.<sup>41</sup> Since a number of states have either abolished or restricted the use of the business/nonbusiness distinction and specific allocation,<sup>42</sup> apportionment, as the only major alternative, is becoming more important as a method for dividing nonbusiness income among the states for tax purposes.

In Iowa, apportionment is statutorily prescribed only for the business income of manufacturing and mercantile concerns. In other industries the income remaining after allocation of non-business income is "specifically allocated or equitably apportioned within and without the state under rules of the director."<sup>43</sup> However, income "derived from the manufacture or sale of tangible personal property" is apportioned to Iowa "in that proportion which the gross sales made within the state bear to the total gross sales."<sup>44</sup>

As mentioned earlier, Iowa is the only state to apportion corporate income entirely upon the basis of sales. The three-factor property-payroll-sales formula has long been the predominant system for apportionment of income among the states for tax purposes. In 1963, twenty-six of the thirty-eight corporate income tax jurisdictions utilized such a three-factor formula.<sup>45</sup> As of this writing, forty-one of the forty-six jurisdictions which impose a corporate income tax either statutorily prescribe a three-factor formula or allow it as an option to the taxpayer.<sup>46</sup>

This apparent uniformity is misleading for several reasons. The states differ on the question of when a particular sale is to

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41. Nemeth and Agee, *supra* note 33, at 249. See also Cahoon and Brown, *The Interstate Tax Dilemma—A Proposed Solution*, 26 NAT'L TAX J. 187, 195 (1973) [hereinafter cited as Cahoon and Brown].

42. As of this writing, 8 of the 46 corporate income jurisdictions do not include specific allocation of nonbusiness income in their statutorily-prescribed method for division of income: Florida, Massachusetts, Michigan, New Hampshire, New Jersey, New York, Rhode Island and Vermont. [1977] STATE TAX GUIDE (CCH) ¶¶ 10,203 - 10,943. One of the bills on interstate commerce now pending in Congress would set a maximum amount of income attributable to a state for corporate income tax purposes by prescribing an apportionment formula for a corporation's entire net income without making any allowance for specific allocation of portions of that income. H.R. 669, 95th Cong., 1st Sess. (1977). *But cf.* Keesling and Warren, *supra* note 17, at 159 (criticizing a predecessor of the present bill for its failure to recognize and allow for specific allocation "in flagrant disregard of this time-honored practice" and creating "serious constitutional questions").

43. IOWA CODE § 422.33(1)(b) (1975).

44. *Id.*

45. REP. 1480, *supra* note 4, at 119.

46. See [1977] STATE TAX GUIDE ¶¶ 10,203-10,943.

be assigned to the taxing state. Iowa defines "gross sales made within the state" to include all "gross sales from goods delivered or shipped to a purchaser within the state regardless of the f.o.b. point or other conditions of the sale."<sup>47</sup> With two exceptions, the Iowa definition of "sales made within the state" conforms to the UDITPA definition.<sup>48</sup>

As of 1963 this "destination" test was by no means universal. In fourteen of the thirty-eight income tax jurisdictions sales were assigned to a state based upon the location of such things as the property at the time of sale (the "origin" test),<sup>49</sup> the sales office through which the sale was negotiated, and the sales activity which generated the sale or acceptance, without regard to the final destination of the product.<sup>50</sup> In the intervening years, however, there has been a very significant trend, both among these states<sup>51</sup> and among those states which have since enacted a corporate income tax,<sup>52</sup> toward adopting the destination test. Nevertheless, as long as such diversity continues, there is still a great danger of overlapping taxation.<sup>53</sup>

Even more recently there has been another trend toward weighting the sales factor at greater than the usual one-third of the apportionment formula. This variation in the weight given the sales factor is another contributor to the lack of uniformity among states using the three-factor taxation formula. In the past six years, four states "have taken a significant step backwards with respect to uniformity"<sup>54</sup> by amending their apportionment formulas to weight the sales factor as one-half,

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47. IOWA CODE § 422.33(1)(b) (1975).

48. The two exceptions are that UDITPA also attributes to the taxing state sales to the United States government and sales made into a state in which the taxpayer is not taxable if the property is shipped from a place of storage within the taxing state. These are called the UDITPA "throwback" provisions. UDITPA § 16(a)-(b). As a matter of fact, the Iowa statute has been amended twice recently to adopt essentially the UDITPA wording without the throwback provisions. 1971 Iowa Acts ch. 165, §§ 36-37; 1975 Iowa Acts ch. 210, § 1.

49. The UDITPA throwback provisions adopt this "origin" test for sales to the United States government and sales to purchasers located in jurisdictions where the taxpayer is not taxable. See note 48 *supra*.

50. REP. 1480, *supra* note 4, at 120-21.

51. See, e.g., 1967 Conn. Pub. Acts no. 586, § 1; 1966 Ky. Acts ch. 176 pt. I, § 6; 1971 Wis. Laws ch. 125, § 373. See also text accompanying notes 93-94, *infra*.

52. See, e.g., 1969 Me. Pub. & Spec. Acts ch. 154, § F(1); 1965 N.M. Laws ch. 203, § 17; 1975 Pa. Laws no. 228, § 52.

53. See *Developments in the Law*, *supra* note 37, at 1012.

54. PETERS, *supra* note 21, at 956.

and each of the other two factors as only one-fourth, of the overall formula.<sup>55</sup>

Lastly, with respect to the Iowa division of income system, the statute does provide that, if upon objection by the taxpayer "the director shall conclude that the method of allocation and apportionment theretofore employed is in fact inapplicable and inequitable," he "shall redetermine the taxable income by such other method of allocation and apportionment as seems best calculated to assign to the state for taxation the portion of the income reasonably attributable to business and sources within the state" not to exceed the amount computed under the statutory rules.<sup>56</sup> Most states have such a "safety valve" clause. In at least one state, which previously had not provided for such director discretion in its statutes or regulations, the administrator did permit an extrastatutory tax settlement in those cases where use of the prescribed formula would produce an "unduly harsh result."<sup>57</sup> The UDITPA provides for the use of alternate methods in cases where the statutory result does "not fairly represent the extent of the taxpayer's business activity in this state."<sup>58</sup> However, at least with respect to the UDITPA provision, "departures from the basic formula should be avoided except where reasonableness requires."<sup>59</sup> In most states such provisions are rarely used.<sup>60</sup>

### C. *The Moorman Decision*

Under the discretionary provision in the Iowa statute the State Tax Commission had allowed Moorman to use the standard three-factor formula to apportion its "business" income to the state from 1949, the first fiscal year in which Moorman filed an Iowa return, until the fiscal year ending on March 31, 1960. Then, at the direction of the Tax Commission, Moorman utilized the Iowa single-factor sales formula to

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55. 1972 Fla. Laws ch. 72-278; 1975 Mass. Acts ch. 684; 1975 N.Y. Laws ch. 895, § 210 (1st Spec. Sess.); 1973 Wis. Laws ch. 90.

56. IOWA CODE § 422.33(2) (1975).

57. REP. 1480, *supra* note 4, at 235.

58. The alternate methods include (a) separate accounting, (b) the exclusion of one or more apportionment factors, (c) the inclusion of one or more additional apportionment factors, and (d) "any other method." UDITPA § 18.

59. Pierce (author of UDITPA), *The Uniform Division of Income for State Tax Purposes*, 35 TAXES 747, 781 (1957) [hereinafter cited as Pierce]. See also Keesling and Warren, *supra* note 17, at 171-72.

60. See Rep. 1480, *supra* note 4, at 235.

apportion its "business" income to the state for fiscal years 1961 through 1964.<sup>61</sup> However, beginning with fiscal year 1965, Moorman switched back to the standard formula for apportionment of income without the consent of the State Tax Commission.<sup>62</sup> Several years later, the Iowa Director issued an order requiring Moorman to use the one-factor sales apportionment formula for fiscal years 1968 through 1972. Moorman took exception to this order and appealed to the Iowa district court.<sup>63</sup>

The choice between the two formulas involved substantial differences in the amount of Moorman's income to be attributed to Iowa for tax purposes. For example, for fiscal year 1968, Moorman's property, payroll and sales factors for Iowa were 4.08, 15.6 and 22.6 percent respectively.<sup>64</sup> Thus, under the Iowa one-factor sales formula, Moorman's apportionment percentage was 22.6. In comparison, under the standard formula the percentage would have been the arithmetical mean of all three factors—only 14.1.<sup>65</sup> Thus, utilizing the Iowa formula instead of the standard three-factor formula would result in an additional 8.5 percent of Moorman's net income being taxed in Iowa. Moorman argued that between Iowa and its domicile, Illinois, which employs the standard three-factor formula, it was being taxed on 141.8 percent of its income.<sup>66</sup>

Moorman's attack on the original order issued by the Director was based upon three contentions. First, it argued that the Iowa single-factor sales apportionment formula was facially unconstitutional. Second, it contended that even if the formula were not facially unconstitutional, it was unconstitutional as

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61. In 1959, the Supreme Court of the United States decided a case which lowered the jurisdictional barriers to state taxation of out-of-state corporations. *Northwestern States Portland Cement Co. v. Minnesota*, 358 U.S. 450 (1959). See text accompanying notes 110-17, *infra*.

62. On April 27th of 1965, the United States Supreme Court had invalidated the single-factor sales apportionment formula used by the District of Columbia on statutory grounds. *General Motors Corp. v. District of Columbia*, 380 U.S. 553 (1965). See text accompanying notes 180-85, *infra*.

63. 254 N.W.2d at 739-40.

64. The figures for Moorman's Iowa and total property were not given in the opinion. Presumably the 4.08% represented the six warehouses Moorman maintained in the state. The payroll and sales factors were computed as follows: payroll factor = Iowa payroll/total payroll = \$3,739,426/\$23,919,381 = 15.6%; sales factor = Iowa sales/total sales = \$22,102,015/\$97,719,800 = 22.6%.

65. 254 N.W.2d at 740.

66. Had all of the property and payroll which Moorman had in Iowa been located in Illinois, this figure would have been 167%. Wall St. J., Nov. 15, 1977, at 4, col. 1.

applied to Moorman in the disputed years. Finally, it contended that even if the formula was not unconstitutional, either facially or as applied, the failure of the Director to allow Moorman to use an alternative formula constituted an abuse of discretion in this case.<sup>67</sup> The district court accepted Moorman's first contention and held that the statute was facially unconstitutional in violation of the due process and commerce clauses of the United States Constitution and the due process clause of the Iowa Constitution.<sup>68</sup>

The Iowa Supreme Court reversed the district court and held that the Iowa statute was facially constitutional.<sup>69</sup> In addition, the court rejected Moorman's other two contentions and held that the Iowa apportionment formula was not unconstitutional as applied to Moorman and that the Director had not abused his discretion in failing to allow Moorman to use an alternate formula.<sup>70</sup> On November 14, 1977, the United States Supreme Court noted probable jurisdiction.<sup>71</sup> To understand the significance of the *Moorman* case and the effect which it could have upon our present system of interstate taxation, it is necessary to review how this system developed over the years.

## II. INTERSTATE TAXATION: EVOLUTION OF A MONSTER

### A. *Lack of Uniformity: The Source of the Problem*

The adoption of a uniform apportionment formula by all the corporate income tax states has long been recognized as being far more important than the adoption of any particular formula.<sup>72</sup> Some tax authorities feel that no single method of

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67. 254 N.W.2d at 740.

68. The district court held that the Iowa single-factor sales formula violated the commerce clause of the United States Constitution because it:

(a) does not fairly apportion interstate business activity to intrastate tax values;

(b) causes multiple taxation of corporate net income by more than one taxing jurisdiction; and

(c) provides local business with a direct commercial advantage not so enjoyed by interstate business.

254 N.W.2d at 740-41.

69. *Id.* at 750, 752.

70. *Id.* at 754-55.

71. 98 S. Ct. 478, No. 77-454.

72. "What is most needed is a uniform rule. Just what rule shall be selected is less important than the general adoption of the same rule by competing jurisdictions." ADAMS, 1917 NAT'L TAX A. PROCEEDINGS 185, 194. See Hellerstein, *Unitary Business*, *supra* note 10, at 495.

apportionment is best. However, since all methods are somewhat arbitrary, the only right rule is one which will be adopted by all of the taxing states.<sup>73</sup> A uniform apportionment formula would eliminate the possibility of over and undertaxation. Furthermore, it would significantly reduce taxpayer compliance costs and minimize the difficulties inherent in the administration of forty-six different tax systems.<sup>74</sup>

The present system is far from uniform. In 1964 an exhaustive study by a House subcommittee on state taxation found that "the effort to trace income to a supposed source through the sales factor has led to a bewildering maze of complications from which even the most eager taxpayer may be expected to recoil."<sup>75</sup> The result of this bewildering complexity was not burdensome compliance costs nor excessive taxation, but widespread noncompliance, incomplete enforcement and a system which operated "neither by published rules nor under adequate supervision."<sup>76</sup> The burdens of overtaxation, in those relatively few cases where it did occur, and disproportionate compliance costs fell hardest upon small and moderate-sized taxpayers, for whom "the system simply has no relation to their ability to cope."<sup>77</sup> The report concluded that the system "works badly for both business and the States . . . [and] . . . calls upon tax administrators to enforce the unenforceable, and the taxpayer to comply with the uncompliant."<sup>78</sup>

While "some apportionment formulas are clearly unfair, no one formula is agreed to be more appropriate than all others."<sup>79</sup> Each state is motivated by a desire to adopt the formula which is most advantageous, taxwise, to itself.<sup>80</sup> For example, Iowa,

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73. REPORT OF COMMITTEE ON THE APPORTIONMENT BETWEEN STATES OF TAXES ON MERCANTILE AND MANUFACTURING BUSINESS, 1922 NAT'L TAX A. PROCEEDINGS 198, 206; REP. 1480, *supra* note 4, at 130.

74. See Corrigan, *supra* note 38, at 439.

75. REP. 1480, *supra* note 4, at 248. *But cf.* Keesling and Warren, *supra* note 17, at 157 (contending that the seriousness of widespread disparity "has been greatly exaggerated").

76. REP. 1480, *supra* note 4, at 334. For an account of the different ways in which corporations have used this diversified system to escape from being taxed on 100% of their income, see Corrigan, *supra* note 38, at 429-36.

77. REP. 1480, *supra* note 4, at 596. See also Corrigan, *supra* note 38, at 437-38. In 1963, about half of the corporations engaged in interstate commerce had fewer than twenty employees. REP. 1480, *supra* note 4, at 72.

78. REP. 1480, *supra* note 4, at 598.

79. *Developments in the Law*, *supra* note 37, at 967.

80. Hartman, *State Taxation of Interstate Commerce: A Survey and an Appraisal*, 46 VA. L. REV. 1051, 1104 (1960) [hereinafter cited as Hartman].

considered an unindustrialized consumer state, has utilized an apportionment formula based entirely upon sales by destination ever since it adopted the corporate income tax in 1934.<sup>81</sup> On the other hand, New York, a heavily industrialized state, adopted a three-factor formula in 1944, which was based on property, payroll and sales by origin.<sup>82</sup> The latter factor is largely duplicative of property and payroll. Thus, both states adopted formulas which were designed to assign the largest possible fraction of corporate income to themselves.<sup>83</sup>

This tendency toward nonuniform self-interested apportionment formulas was counterbalanced in the manufacturing states by domestic political pressure to adopt less production-oriented formulas. Prior to 1957, North Carolina had apportioned foreign corporation income on the basis of two such formulas. The formula applied to manufacturing firms consisted of two factors, property and manufacturing costs. In contrast, property and sales, assigned on the basis of location of the sales office, were the two factors used in the case of mercantile firms. These production-oriented formulas tended to apportion to the state a large percentage of the income of corporations having substantial assets within the state. They were criticized as being unduly harsh in comparison to other states' systems and a possible deterrent to economic development.<sup>84</sup> In response to mounting pressure from interstate business concerns, a governor's commission recommended the adoption of a three-factor apportionment formula, which assigned sales by destination for all domestic and foreign manufacturing and mercantile corporations. The commission's recommendations were adopted in 1957<sup>85</sup> and on November 17th of that year an advertisement appeared in the New York Times declaring that "North Carolina Reduces Taxes . . . to

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81. 1933-34 Iowa Acts ch. 82, § 28 (Ex. Sess.).

82. 1944 N.Y. Laws ch. 415, § 2. When it initially adopted a franchise tax based on net income in 1917, New York prescribed a three factor formula consisting of property, accounts receivable and stock of other corporations. Accounts receivable were assigned upon an origin basis and stock held in other corporations was assigned on the basis of the physical property of the other corporations. 1917 N.Y. Laws ch. 726, § 1. This formula had the same tendency to apportion a large amount of income to New York, a manufacturing state.

83. *Developments in the Law*, *supra* note 37, at 966.

84. REP. 1480, *supra* note 4, at 123.

85. 1957 N.C. Sess. Laws ch. 1340, § 3.



encourage more industry to locate and expand in the State.”<sup>86</sup>

The following year South Carolina, which had previously employed a two-factor system quite similar to the old North Carolina formula, adopted the three-factor destination-sales formula<sup>87</sup> in order to remain competitive with its neighbor to the north.<sup>88</sup> The following year an advisory legislative council in Virginia recommended that its production-oriented apportionment formula be repealed. The council also recommended the adoption of the North Carolina formula to remove the appearance of discrimination and to promote uniformity.<sup>89</sup> A year later, in 1960, the recommendation was enacted into law.<sup>90</sup>

In response to similar pressures, New York, in 1961, switched from its three-factor, origin-sales formula to one in which the sales factor was computed fifty percent on an “origin” basis and fifty percent on a “destination” basis.<sup>91</sup> The change was made to encourage manufacturing in New York, despite an estimated revenue loss of eight million dollars per year.<sup>92</sup>

Even today, states are still attempting to encourage domestic business development through the adoption of sales-oriented apportionment formulas. Wisconsin, one of the four states which has recently adopted a double-weighted sales formula,<sup>93</sup> published a study of comparative state tax burdens one year after enactment which noted that “[w]hen compared with the 1973 study, tax costs in Wisconsin have decreased dramatically *ranking Wisconsin lower than every state initially studied, except Texas.*”<sup>94</sup> Thus, there is a very definite trend among manufacturing states to moderate their self-interested

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86. REP. 1480, *supra* note 4, at 123-24. *But cf.* Due, *Studies of State-Local Tax Influences on Location of Industry*, 14 NAT'L TAX J. 163 (1961). (“While the statistical analysis and study of location factors are by no means conclusive, they suggest very strongly that the tax effects [of various state and local tax levels] cannot be of major importance.”) *Id.* at 171.

87. 1958 S.C. Acts no. 731.

88. REP. 1480, *supra* note 4, at 124-25.

89. These recommendations were made despite the committee's reservations that the criticism of the old system was “not entirely well founded.” *Id.* at 125-26.

90. 1960 Va. Acts. ch. 442.

91. 1961 N.Y. Laws ch. 713, § 12.

92. *Developments in the Law*, *supra* note 37, at 976-77 & n.126.

93. See text accompanying notes 54-55, *supra*.

94. WISCONSIN DEP'T OF REVENUE, COMPARATIVE TAX BURDENS ON SELECTED MANUFACTURERS IN FIFTEEN STATES 1 (1974) (emphasis in original).

apportionment systems and adopt more sales-oriented formulas.

In contrast, there is little local pressure in consumer states to moderate their self-interested formulas and adopt more production-oriented formulas which emphasize the property and payroll factors.<sup>95</sup> Indeed, the opposite appears to be true. In the 1950's a number of consumer or market states adopted more sales-oriented approaches to income apportionment.<sup>96</sup> These changes were motivated, in part, by revenue concerns.<sup>97</sup> However, as with the manufacturing states, the prospect of improving the tax climate for the politically influential home industry while simultaneously attracting new business into the states may well have been the controlling consideration.<sup>98</sup>

Perhaps the trend in both manufacturing and market states to "'export' taxes by imposing them on nonvoting out-of-state taxpayers" can best be explained by the simple fact that such out-of-state corporations are not represented in the legislatures which impose the taxes.<sup>99</sup> "Interstate commerce . . . is a legislator's dream: a lush source of tax revenue, the burden of which falls largely on those who cannot vote him out of office. It is the old problem of taxation without representation."<sup>100</sup>

### B. *Bigger and Bigger Stakes: The Source of the Conflict*

Despite its inherent tendency toward duplicitous taxation of interstate commerce, interstate division of income and apportionment was the source of relatively little controversy before the 1950's.<sup>101</sup> This may be due to the fact that income taxation is a relatively recent innovation in public finance. The first modern corporate income tax was passed by Wisconsin in 1911.<sup>102</sup> After the federal tax was enacted in 1913, more states

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95. See *Developments in the Law*, *supra* note 37, at 976.

96. See text accompanying notes 108-09, *infra*.

97. Studenski, *The Need for Federal Curbs on State Taxes on Interstate Commerce: An Economist's Viewpoint*, 46 VA. L. REV. 1121, 1125 (1960) [hereinafter cited as Studenski]. But cf. Britton, *State Taxation of Extraterritorial Value: Allocation of Sales to Destination*, 46 VA. L. REV. 1160, 1168 (1960) [hereinafter cited as Britton] (indicating that whether a net revenue loss or increase resulted from the changes was a question in which the states were "not overly interested").

98. Britton, *supra* note 97, at 1168. See also Studenski, *supra* note 97, at 1125.

99. See Corrigan, *supra* note 38, at 424.

100. MENDELSON, EPILOGUE TO F. FRANKFURTER, *THE COMMERCE CLAUSE* 118 (1964). See also Britton, *Taxation Without Representation Modernized*, 46 A.B.A.J. 369 (1960).

101. PETERS, *supra* note 21, at 901-02.

102. 1911 Wis. Laws ch. 658.

began to adopt the income tax so that by 1960 thirty-seven of the fifty states and the District of Columbia imposed corporate income taxes.<sup>103</sup> Although the corporate income tax accounted for only about five to six percent of the general revenues of all the states during these years, it was a significant source of revenue in the taxing states, accounting for about ten percent of the total taxes collected in those states.<sup>104</sup>

During this developmental period, these states did not aggressively seek to tax interstate corporations.<sup>105</sup> Their failure to do so was partially attributable to the fact that interstate commerce was not as extensive as it is today. Moreover, as recently as 1951 in the case of *Spector Motor Service v. O'Connor*,<sup>106</sup> the Supreme Court had reaffirmed its doctrine that a state could not tax a corporation for the privilege of carrying on a business that was exclusively interstate in character. States attempted to tax only those corporations which maintained some permanent establishment within their borders, such as a manufacturing plant, a warehouse, a store or a regular office. As a result, the small and medium-sized firms, manufacturing in a few states and selling in many more, were not particularly burdened by lack of uniformity in state division of income. The relatively few large corporations which did have permanent establishments in more than just a few states were unable to pressure the legislatures in those states to bring about a more uniform system of state taxation.<sup>107</sup>

After World War II, however, revolutionary advancements in communication, transportation and distribution, as well as the increasing sophistication of the structuring of corporate enterprise, made it possible for businesses to operate at great distances from their ultimate markets.<sup>108</sup> During the 1950's, the so-called consumer or market states reacted by seeking to impose their corporate income taxes on foreign corporations and adopting apportionment formulas with destination sales as a prime element.<sup>109</sup> Although state apportionment systems have

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103. REP. 1480, *supra* note 4, at 100-03.

104. *Id.* at 110-11.

105. PETERS, *supra* note 21, at 901-02.

106. 340 U.S. 602, 609 (1951), *citing* Alpha Cement Co. v. Massachusetts, 268 U.S. 203, 216-17 (1925).

107. Studenski, *supra* note 97, at 1121, 1124.

108. Corrigan, *supra* note 38, at 424-25.

109. Studenski, *supra* note 97, at 1124-25; see also text accompanying notes 95-100, *supra*.

always been skewed toward enhancing state revenues, and often at the expense of free trade, the burgeoning of interstate commerce coupled with more aggressive out-of-state enforcement by state tax administrators brought the problem to the forefront during the 1950's.

In 1959, the Supreme Court decided the companion cases of *Northwestern States Portland Cement Co. v. Minnesota* and *Williams v. Stockham Valves & Fittings*,<sup>110</sup> two cases which ended the relative calm in the area of interstate corporate taxation.<sup>111</sup> In *Northwestern*, Minnesota had attempted to impose an income tax on an Iowa corporation whose only physical connection with the state was a rented sales office with two salesmen and a secretary. In the *Stockham* case, Georgia attempted to tax a Delaware corporation which maintained a single rented sales office with only one salesman in the state. Both states utilized a three factor formula, with sales by destination constituting one-third of the apportionment fraction.<sup>112</sup>

The Supreme Court upheld the taxes in both cases, saying that "net income from interstate operations of a foreign corporation may be subjected to state taxation provided the levy is not discriminatory and is properly apportioned to local activities within the taxing state forming sufficient nexus to support the same."<sup>113</sup> The *Spector Motor Service v. O'Connor* holding that a state could not tax business that was exclusively interstate was distinguished. While the Minnesota and Georgia taxes were imposed directly upon net income, the tax in the *Spector* case, although measured by net income, was imposed upon the privilege of doing business within the state.<sup>114</sup> This distinction has been severely criticized<sup>115</sup> and at least one writer has contended that the *Spector* interstate commerce immunity doctrine has since been entirely abandoned.<sup>116</sup>

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110. 358 U.S. 450 (1959).

111. PETERS, *supra* note 21, at 901-02.

112. Whereas Minnesota employed the standard three-factor formula, Georgia's formula included an inventory factor in lieu of the standard property element. 358 U.S. at 453-57.

113. *Id.* at 452.

114. *Id.* at 463-64.

115. See, e.g., Hartman, *supra* note 80, at 1100 (saying that this "judicially spawned distinction . . . has about as much substance as soup made from the shadow of an emaciated sparrow"). See also *Developments in the Law*, *supra* note 37, at 961.

116. Hellerstein, *State Taxation of Interstate Business and the Supreme Court*,

Three justices dissented in *Northwestern* and, in one of the two dissenting opinions, Justice Frankfurter predicted that the case would result in significant compliance burdens for the "thousands of relatively small or moderate size corporations doing exclusively interstate business spread over several states" and that the volume of apportionment litigation "will be multiplied many times when such formulas are applied to the infinitely larger number of other businesses which are engaged in exclusively interstate commerce."<sup>117</sup>

### III. THE ELUSIVE GOAL OF UNIFORMITY

#### A. *The Sales Factor in the UDITPA: A Backward Step Toward Uniformity*

In 1957, two years before the *Northwestern* decision, the National Conference of Commissioners on Uniform State Laws and the American Bar Association adopted the UDITPA.<sup>118</sup> The UDITPA includes the standard apportionment formula with three equally-weighted factors: property, payroll and sales by destination.<sup>119</sup>

Inclusion of the sales factor, the most controversial and most criticized factor, has been defended on the basis that it offsets the effects of the property and payroll factors and protects the interest of the state of destination. This seems appropriate since the market state is essential to the production of sales income.<sup>120</sup> There was also a second and more pragmatic reason for the inclusion of a sales factor in the UDITPA formula:

The much debated adoption of a sales factor in apportionment formulas is attributable to at least two fact patterns. Formula development has reflected the varying economic positions of the states and, to a lesser degree, the assumed need for a formula satisfactory to both "manufacturing" and "market" states as a basis for compromise leading to formula uniformity. . . . Thus, apportionment theory came to in-

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1974 Term: *Standard Pressed Steel and Colonial Pipeline*, 62 VA. L. REV. 149, 188 (1976).

117. 358 U.S. at 474-75.

118. UDITPA (U.L.A.) Hist. Note, at 365.

119. UDITPA § 9.

120. See Lynn, *Formula Apportionment of Corporate Income for State Tax Purposes: Natura Non Facit Saltum*, 18 OHIO ST. L.J. 84, 98 (1957) [hereinafter cited as Lynn].

clude sales as a means of balancing claims of market states vis-a-vis industrial states. . . . UDITPA . . . not surprisingly reflects existing apportionment theory.<sup>121</sup>

Similar reasons were given for the Act's adoption of the "destination" test for sales.<sup>122</sup> The "origin" test was rejected because it merely duplicated the property and payroll factors and failed to recognize the contribution of the consumer states toward the production of income.<sup>123</sup> The destination test was preferred over standards based on negotiation or origin because it is less susceptible to manipulation for tax purposes.<sup>124</sup>

Following the *Northwestern* decision and the apparent lowering of jurisdictional taxation barriers, interstate taxation has become a source of heated controversy<sup>125</sup> with use of the sales factor creating the most controversial issues. This may be attributable to the difficulty encountered in determining precisely where a particular sale takes place.<sup>126</sup> Perhaps a more fundamental explanation is that the sales factor involves more basic clashes of interest than the property and payroll factors. The differences in the definitions of the latter two factors "do not appear to be grounded in considerations more important than the tastes and judgment of the draftsmen of existing laws."<sup>127</sup>

A major problem in testing the validity of the sales factor is the lack of a definitive rule by which to judge a particular tax or apportionment formula. The United States Supreme Court has, in past cases, applied at least two tests, a "source" test and a "benefits" test.

In upholding an apportionment formula against due process

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121. Lynn, *The Uniform Division of Income for Tax Purposes Act Re-Examined*, 46 VA. L. REV. 1257, 1262 (1960) (emphasis added).

122. The Council of State Governments had proposed a tripartite sales factor including negotiation, origin and destination as partial tests. The Controllors Institute Committee had recommended a two-part sales factor including only the origin and destination tests. Lynn, *supra* note 120, at 94, 99.

123. Pierce, *supra* note 59, at 780.

124. Hartman, *State Taxation of Corporate Income from a Multistate Business*, 13 VAND. L. REV. 21, 80 (1959) [hereinafter cited as Hartman, *Multistate Business*.]

125. See, e.g., 46 VA. L. REV. 1051 (1960) (an entire issue was devoted to the problems of interstate taxation); *Symposium, State Taxation of Interstate Business*, 27 VAND. L. REV. 335 (1976).

126. Hartman, *Multistate Business*, *supra* note 124, at 74. See also REP. 1480, *supra* note 4, at 196.

127. Hellerstein, *Allocation and Nexus in State Taxation of Interstate Business*, 20 TAX. L. REV. 259, 267 (1965) [hereinafter cited as Hellerstein, *Interstate Business*].

and commerce clause attacks, the Court in *Underwood Type-writer Co. v. Chamberlain*<sup>128</sup> illustrated its application of the "source" test:

The profits of the corporation were largely earned by a series of transactions beginning with manufacture in Connecticut and ending with sale in other States. . . . The legislature in attempting to put upon this business its fair share of the burden of taxation was faced with the impossibility of allocating specifically the profits earned by the processes conducted within its borders.<sup>129</sup>

The application of the "source" test, however, is beset with the same difficulties faced in dealing with the causation issue in negligence cases. A great many things may be said to have been the "cause" or "source" of a particular amount of income. The questions asked to determine the source of income are similar to those posed to determine the legal cause of an event: (1) whether but for the supposed cause, the effect would not have occurred, and (2) whether the supposed cause "substantially contributed" to the effect so that it may properly be considered a cause thereof. Thus, a particular state's apportionment system is valid under the "source" test if the income apportioned to the state would not have been produced but for the involvement of the taxing state and the taxing state has "substantially contributed" to the production of that income.

Clearly, the sales factor complies with the first requirement of this two-step analysis. Without the market state, the state to which the sales factor apportions income, there would be no profits at all. The market is a *sine qua non* of income for any unitary business, a point conceded even by the opponents of the sales factor.<sup>130</sup> However, this fact alone does not automatically give rise to a right on the part of the market state to tax that income. Something more is necessary. If this was a sufficient basis for a state to exercise its taxing power, the state of birth of any successful entrepreneur might claim a portion of

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128. 254 U.S. 113 (1920). For a discussion of the *Underwood* case itself, see text accompanying notes 175-77, *infra*.

129. 254 U.S. at 120-21, *quoted in* *General Motors Corp. v. District of Columbia*, 380 U.S. 553, 560-61 (1965).

130. See, e.g., Harriss, *Economic Aspects of Interstate Apportionment of Business Income*, 37 TAXES 327, 362 (1959) [hereinafter cited as Harriss].

his or her income throughout his or her entire business life, regardless of the state in which that business was conducted. Without a state of birth, no entrepreneur would be able to produce any income. With the *sine qua non* subissue virtually undisputed, the crux of the "source" controversy centers around whether the market state "substantially contributes" to the earning of interstate income so as to properly be considered a source of that income.

Both proponents and opponents of the sales factor recognize that capital and labor are sources of interstate corporate income, and, consequently, that property and payroll factors are properly included in the apportionment formula.<sup>131</sup> Opponents of the sales factor contend, however, that labor and capital are the only sources of income.<sup>132</sup> As of the time of sale, all profits have been earned and, after the sale, a corporation does not earn income within the market state simply by virtue of shipments into that state.<sup>133</sup> Although the actual process of selling and marketing is recognized as contributing to income,<sup>134</sup> to include sales as a separate factor in the apportionment formula is to arbitrarily assume that a dollar of property or payroll devoted to selling is "substantially more productive in the derivation of net income" than the dollar devoted to other aspects of the unitary business.<sup>135</sup> Furthermore, the sale itself does not produce income; it simply represents the mutual exchange of equivalent benefits.<sup>136</sup> Lastly, it is argued that the uncertain way in which the market contributes to income is responsible for the difficulty of assigning sales to a particular jurisdiction.<sup>137</sup>

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131. See, e.g., Cox, *The Interstate Tax Problem*, 38 TAXES 417, 421-22 (1960) [hereinafter cited as Cox]. Some supporters of a two-factor, property-payroll apportionment formula suggest that, perhaps the weighting of the two factors should be changed to, for example, one to four, so as to reflect the proportionate contribution of capital and labor, respectively, to the production of income in the economy as a whole. See, e.g., Harriss, *supra* note 130, at 363.

132. Harriss, *supra* note 130, at 362; Barnes, *Prerequisites of a Federal Statute Regulating State Taxation of Interstate Commerce*, 46 VA. L. REV. 1269, 1278 (1960) [hereinafter cited as Barnes].

133. Britton, *supra* note 97, at 1166.

134. Harriss, *supra* note 130, at 362.

135. Barber (then Senior Tax Counsel of the Wisconsin Dep't of Taxation), *A Suggested Shot at a Gordian Knot of Income Apportionment*, 13 NAT'L TAX J. 243, 248 (1960) [hereinafter cited as Barber].

136. Studenski, *supra* note 97, at 1131.

137. Cf. Barnes, *State Taxation of Interstate Commerce: Nexus and*



The supporters of the sales factor contend that the market does contribute to the production of income,<sup>138</sup> and that sales, like manufacturing, should be recognized as a "major taxable event."<sup>139</sup> For example, during World War II, the prices of second-hand cars increased sharply due to the dearth of new cars available. It was this enhanced market, rather than the application of property and payroll, which caused skyrocketing used car profits. Furthermore, the importance of the market is evidenced by the vast amounts of money spent to manipulate it. Lastly, proponents of the sales factor argue that the classical economist's conception of capital and labor as the source of income, regardless of its merits, "has little or no bearing on tax policy and, indeed, is contrary to tax postulates widely used in this country."<sup>140</sup>

Use of the sales factor is also a controversial issue under the "benefits" test as applied by the Supreme Court. This test differs from the "source" test in that the latter inquires as to where the income arose, while the former looks to see what governmental services were utilized in the production of that income. Naturally, the two tests often yield the same result. However, even though some writers have argued that this is always the case,<sup>141</sup> the two tests would seem to give rise to different results in certain cases. For example, a corporation might operate two factories in two different states each manufacturing a different product, only one of which is sold at a profit. Although the "source" test would tax all of the income in the state of the profit-making product, the "benefits" test

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*Apportionment*, 48 MARQ. L. REV. 218, 224 (1964) (arguing that the "unsoundness" of the sales factor is responsible for the willingness of UDITPA states to adopt the "origin" test in "throwback" situations). See also notes 48-49, *supra*. But cf. Lynn, *The Uniform Division of Income for Tax Purposes Act Re-Examined*, 46 VA. L. REV. 1257, 1266 (1960) (arguing that the throwback provisions for sales into states where the taxpayer is not taxable should be eliminated precisely because of this inconsistency).

138. Cf. Lynn, *The Uniform Division of Income for Tax Purposes Act Re-Examined*, 46 VA. L. REV. 1257, 1267 (1960) ("With respect to the sales factor, it is difficult, at least for this writer, to reject completely the concept that the market contributes to the generation of income.").

139. Cox, *supra* note 131, at 422. But cf. Harriess, *supra* note 130, at 362 n.3 (saying that "[t]here are methods of taxing sales, of course, but the net income tax is not one of them.").

140. Hellerstein, *Interstate Business*, *supra* note 127, at 274-75. See also *State Taxation of Interstate Commerce: Roadway Express, The Diminishing Privilege Tax Immunity, and the Movement Toward Uniformity in Apportionment*, 36 U. CHI. L. REV. 186, 216 (1968):

141. See, e.g., Barnes, *supra* note 132, at 1276-77.

would tax each factory in proportion to the state services afforded it.<sup>142</sup>

Support for the "benefits" test is found in the following language from *Wisconsin v. J.C. Penney Co.*:<sup>143</sup>

For constitutional purposes the decisive issue turns on the operating incidence of a challenged tax. . . . [The] test is whether property was taken without due process of law, or if paraphrase we must, whether the taxing power exerted by the state bears fiscal relation to protection, opportunities and benefits given by the state. The simple but controlling question is whether the state has given anything for which it can ask return.<sup>144</sup>

Several difficulties are encountered in applying the "benefits" test to the sales factor in state income tax apportionment formulas. The first difficulty is that the income tax itself does not satisfy the "benefits" test because corporate income is a poor index of benefits received from goods and services provided by the government. For that reason, some authorities argue that the income tax is an undesirable state tax.<sup>145</sup> Others argue that, despite this defect, the income tax is more desirable from an economic standpoint than other forms of taxation because it falls upon individuals who are currently able to pay and does not discriminate among taxpayers on the basis of occupation.<sup>146</sup> In any event, the states are not about to give up this valuable source of revenue, and they will continue to impose the income tax even if it fails to conform to the "benefits" principle.<sup>147</sup>

Another problem with the "benefits" test is that it is elusive and often fails to furnish any useful test of constitutionality. Although some types of taxes, such as a highway use tax, can easily be characterized as a *quid pro quo*, most types of government expenditures, such as those for education and defense, are not susceptible to this "bargained-for" analysis. The taxes collected to pay for these expenditures "can be regarded only

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142. See REP. 1480, *supra* note 4, at 158-59.

143. 311 U.S. 435 (1940).

144. *Id.* at 44, *quoted in* *Northwestern States Portland Cement Co. v. Minnesota*, 358 U.S. 450, 465 (1959).

145. Morss, *An Evaluation of the Report on State Taxation*, 18 NAT'L TAX J. 297, 303 (1965) [hereinafter cited as Morss].

146. *Developments in the Law*, *supra* note 37, at 1000-01.

147. Morss, *supra* note 145, at 303.

as exactions by the state for the general benefits of living under an organized government.”<sup>148</sup> Even for these expenditures, however, it is still relevant to inquire whether the tax imposed to pay for them is subject to local political check.<sup>149</sup>

Furthermore, under the “benefits” principle the beneficiary is aware that the government goods and services he or she is enjoying are not costless. Consequently, some writers argue that even though benefit taxation will not guarantee an optimum resource allocation, on efficiency grounds it is still probably the best general finance criterion for state government.<sup>150</sup> This argument suggests a third test, an “efficiency” test, which has not been endorsed by the Supreme Court. Under this analysis, a tax is inadequate if it exhibits a “tendency to induce sacrifices of efficiency, to cause modification of business methods in ways which are designed to save tax rather than to enhance efficiency and productivity.”<sup>151</sup>

Some writers argue that the sales factor complies with the “benefits” test and that its inclusion in the apportionment formula is in recognition of the economic benefits which flow from the governmental services furnished by the customer’s state.<sup>152</sup> While the interstate corporation makes large investments and maintains substantial payrolls in the manufacturing state, the “exploited” consumer state “receives little or no budgetary gain for having furnished the market.”<sup>153</sup>

Opponents of the sales factor characterize the benefits provided by the market state to the foreign producer as “obscure”<sup>154</sup> and “very modest and very indirect.”<sup>155</sup> Certainly, the benefits conferred by the market state are not nearly as

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148. *Developments in the Law*, *supra* note 37, at 957.

149. *Id.* at 957-58.

150. Morss, *supra* note 145, at 300 & n.14.

151. Harriss, *supra* note 130, at 361. Perhaps this test should also include a consideration of the tendency of a tax to fall in such a way that the prices of goods subject to the tax would reflect all the government services and private resources which went into making the product, but no more. Such a tax would foster efficiency in both the production and the consumption of goods. Manufacturers and consumers would continue to produce and buy goods only up to that point where the amount of goods expended to produce the product began to exceed the utility of the product itself.

152. N.Y. State Bar Association Tax Section Committee on Interstate Taxation, *Proposals for Improvement of Interstate Taxation Bills* (H.R. 1538 and S. 317), 25 TAX LAWYER 433, 459 (1972) [hereinafter cited as N.Y. State Bar A. Tax Section].

153. Cox, *supra* note 131, at 422.

154. Barber, *supra* note 135, at 249.

155. Studenski, *supra* note 97, at 1130.

palpable as the services, such as police and fire protection, provided in the state of manufacture.<sup>156</sup>

It is also contended that the market state is not being exploited at all, because a sale is merely an exchange of equivalent benefits.<sup>157</sup> The fact that the consumer is willing to make the exchange means that in his or her mind the product received is worth the money paid. To the extent that the consumer would have been willing to pay more, he or she receives a profit and the wealth of the market state is increased.<sup>158</sup> It is for this reason (and not because of a desire to benefit the out-of-state producer) that the consumer state tolerates the out-of-state producer in its market.<sup>159</sup>

Several other arguments, both for and against the sales factor, are based upon pragmatic considerations rather than the theoretical justification of sales as an apportionment factor. For example, a clear majority of the authorities endorse the adoption of the three-factor formula, either because the failure to do so would reduce what uniformity has been achieved up until now,<sup>160</sup> or because it is the only formula capable of widespread adoption without serious disruption of state revenues.<sup>161</sup>

Because less industrialized states have come to rely on the revenues collected from out-of-state producers by means of their three-factor formulas,<sup>162</sup> it is argued that the sales factor should be retained to allow the market states to share in income tax revenues.<sup>163</sup> Nevertheless, both the fairness of such an income transfer<sup>164</sup> and the desirability of accomplishing it

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156. See Hartman, *Multistate Business*, *supra* note 124, at 78 n.208.

157. Studenski, *supra* note 97, at 1131.

158. Barnes, *supra* note 132, at 1278.

159. Studenski, *supra* note 97, at 1130.

160. See, e.g., Keesling and Warren, *supra* note 17, at 159.

161. See, e.g., Nemeth and Agee, *supra* note 33, at 250. Cf. Barnes, *supra* note 132, at 224-25 (arguing that the sales factor, though "illogical, unreasonable, and groundless," cannot be eliminated without a substantial increase in the total tax take or a drastic revision of rates, and that, consequently, a sales-by-origin factor should be adopted).

162. N.Y. State Bar A. Tax Section, *supra* note 152, at 459. In recognition of this dependence, some proponents of a federally mandated two factor formula have proposed short run federal aid to those states hardest hit by such a change. Morss, *supra* note 145, at 301.

163. Hellerstein, *Interstate Business*, *supra* note 127, at 276.

164. In 1963, there was only a very rough correlation between the various states' percentages of civilian income earned in manufacturing and average per capita incomes. Thus, use of the sales factor to apportion income to consumer states did not

through state income tax apportionment<sup>165</sup> have been questioned.

However, a more fundamental dispute involves the theoretical validity of the market state/manufacturing state distinction.<sup>166</sup> If such a distinction is not economically sound, the chances of effectuating any transfer of income between states through the use of apportionment formulas are diminished, or even eliminated.<sup>167</sup> This was suggested in 1963 by the House subcommittee which estimated that a nationwide conversion to a two-factor property-payroll apportionment formula would not cause more than a 1.6 percent decrease in any one state's total revenues.<sup>168</sup> The reliability of the report's projections, however, has been questioned because of the use of total revenues, as opposed to income tax revenues, as a standard for analyzing the impact of the switch,<sup>169</sup> and because of several questionable assumptions used in arriving at the estimates.<sup>170</sup>

In any event, opponents of the sales factor argue that the

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serve to transfer income to where it was needed the most. See REP. 1480, *supra* note 4, at 543-50.

165. "To permit the low income states to help themselves to the resources of the high income states [through the use of sales apportionment] is to open the doors wide to taxation chaos." Studenski, *supra* note 97, at 1133. Professor Studenski argues that such income redistribution should only be implemented through the federal government.

166. See REP. 1480, *supra* note 4, at 532-34.

167. Cf. Barnes, *supra* note 132, at 1277-78 (saying that no state can maintain a net trade deficit for long, and that, consequently, "sharing the wealth . . . cannot be accomplished by application of the 'market state' concept").

168. Only two jurisdictions were estimated to have more than a 1% decrease in total revenues, Colorado and the District of Columbia. REP. 1480, *supra* note 4, at 556-57. Colorado, which employed a two-factor property-sales formula at the time, has since adopted the Multistate Tax Compact, which includes the three-factor UDITPA formula in its provisions, thereby reducing the weight of the sales factor from one-half to one-third. The single-factor destination-sales formula used by the District of Columbia at that time was found invalid on statutory grounds in 1965. See text accompanying notes 180-185, *infra*.

169. According to the subcommittee's estimates, conversion to the standard three-factor formula, instead of the two-factor property-payroll formula, would result in differences of more than 20% of the total income tax revenues under the latter formula in four jurisdictions. Thus, the four jurisdictions, the District of Columbia, Idaho, New Mexico and North Dakota, could lose more than one-fifth of their income tax revenues, ranging up to 47% in the latter state. See REP. 1480, *supra* note 4, at 542.

170. See Hellerstein, *Interstate Business*, *supra* note 127, at 270-73 & n.57. While not expressing an opinion as to the accuracy of the report results, Professor Hellerstein concludes that "we simply do not have an adequate statistical basis for proceeding with safety or confidence . . . to give up the receipts factor or the sales destination test." *Id.* at 272.

cost alone of complying with a tax system employing such a factor precludes its use in an apportionment formula.<sup>171</sup> While figures used in computing the property and payroll factors are easy to determine and assign to the proper state, "no sales factor can be adopted without creating at least some difficulty for a substantial number of multistate taxpayers."<sup>172</sup> To the extent that sales are attributed to states where the taxpayer would not otherwise be taxable, the sales factor increases compliance expenses as a result of the greater number of returns which must be filed.<sup>173</sup> Additionally, the difficulties involved with enforcement of a tax against parties whose only connection with the taxing state is the sale of products within its borders often results in a haphazard and arbitrary determination of who must ultimately pay tax.<sup>174</sup>

*B. The Court, The Congress and the States:  
Several Steps Sideways Toward Uniformity*

Nothing the Supreme Court has done up to this point has significantly narrowed state discretion in the choice of income tax apportionment formulas. It has never invalidated such a formula on constitutional grounds, as the trial court did in the *Moorman* case. On the contrary, by implication or otherwise, the Supreme Court has recognized the validity of several of the state apportionment formulas which have come before it.

The first such formula to be challenged in the Supreme Court was a single-factor formula for manufacturing and trading companies, based entirely upon real and tangible personal property within the state. The Court upheld that formula in *Underwood Typewriter Co. v. Chamberlain*<sup>175</sup> against an attack by a manufacturing firm located primarily in the taxing state, which sold a substantial portion of its goods in other states. Noting that the profits of the corporation "were largely earned by a series of transactions beginning with manufacture in Connecticut and ending with sales in other States," the Court said

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171. Cf. Harriss, *supra* note 130, at 327 (suggesting that a significant portion of even corporate compliance expenditures are borne by the public by way of a reduced federal income tax base).

172. REP. 1480, *supra* note 4, at 526.

173. See Hartman, *Multi-state Business*, *supra* note 124, at 79, cf. Barnes, *supra* note 137, at 1281 (arguing for a sales-by-origin factor for this reason).

174. See Studenski, *supra* note 97, at 1134-37.

175. 254 U.S. 113 (1920).

that the corporation had simply not shown that its instate profits were less than the 47 percent arrived at by apportionment.<sup>176</sup> In several other cases challenging the application, as opposed to the facial validity, of single-factor property formulas, the Supreme Court has reaffirmed its *Underwood* holding.<sup>177</sup>

The Court approved the use of the standard three-factor formula in *Butler Brothers v. McColgan*: "We cannot say that property, payroll and sales are inappropriate ingredients of an apportionment formula."<sup>178</sup> Similarly, in the companion cases of *Northwestern States Portland Cement Co. v. Minnesota* and *Williams v. Stockham Valves & Fittings*, the Court, by holding that the respective states had jurisdiction to tax the corporations, implicitly held that the standard three-factor formula, and a modified three-factor formula (using inventory instead of property as a factor) were free from constitutional defect.<sup>179</sup>

More recently, however, the United States Supreme Court has called into serious question the constitutionality of an apportionment formula based entirely upon the sales factor. In *General Motors Corp. v. District of Columbia*,<sup>180</sup> the issue involved the statutory validity of regulations promulgated by the District Commissioners providing for the apportionment of income by sales alone. Although the statute provided that the tax should be imposed only on that income "as is fairly attributable to any trade or business carried on or engaged in within the District," there was an express statutory provision that "[i]f the trade or business of any corporation . . . is carried on . . .

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176. *Id.* at 120-21. Despite this indication in *Underwood* that a factual presentation may be sufficient to show the unconstitutionality of a particular application of an apportionment formula, the Court has shown a great reluctance to accept separate accounting, the only other method of making such a determination, to show the inaccuracy of the result arrived at by apportionment. See, e.g., *Butler Bros. v. McColgan*, 315 U.S. 501 (1942); *Bass, Ratcliff & Gretton, Ltd. v. State Tax Comm'n*, 266 U.S. 271 (1924). But cf. *Hans Rees' Sons, Inc. v. North Carolina ex rel. Maxwell*, 283 U.S. 123 (1931) (holding the application of an apportionment formula unconstitutional despite the absence of actual evidence of unfairness due to its exclusion at the trial level).

177. See, e.g., *Bass, Ratcliff & Gretton v. State Tax Comm'n*, 266 U.S. 271 (1924) (formula also including the intangible properties of accounts receivable and, to a limited extent, shares of stock); *Hans Rees' Sons, Inc. v. North Carolina ex rel. Maxwell*, 283 U.S. 123 (1931).

178. 315 U.S. 501, 509 (1942).

179. 358 U.S. 450 (1959). See also text accompanying notes 110-117, *supra*.

180. 380 U.S. 553 (1965).

both within and without the District, the net income derived therefrom shall . . . be deemed to be income from sources within and without the District."<sup>181</sup> The Court held the sales apportionment regulation invalid under this statute.<sup>182</sup>

The decision may be seen as simply an application of the latter provision of the District's statute, as the Court expressly disavowed an intention "to take any position on the constitutionality of a state income tax based on the sales factor alone."<sup>183</sup> However, language in the opinion certainly indicates that the status of such a tax is in serious doubt.<sup>184</sup> After quoting extensively from the language in *Underwood* applying the series-of-transactions "source" approach, the Court stated that:

The standard three-factor formula can be justified as a rough, practical approximation of the distribution of either a corporation's sources of income or the social costs which it generates. By contrast, the geographic distribution of a corporation's sales is, by itself, of dubious significance in indicating the locus of either factor.<sup>185</sup>

Thus, the Court has indicated that the single-factor-sales apportionment formula may not conform to the standards of either the "source" test or the "benefits" test.<sup>186</sup> With respect to the overall problem of interstate taxation, the Supreme Court is simply not in a position to bring about uniformity among the states. While it may strike down particular apportionment formulas in flagrant cases, it is not likely that the Court will choose one among the several prevailing apportionment systems and invalidate all conflicting formulas.<sup>187</sup> Consequently, several writers have concluded that if the present system of interstate taxation is to be made more uniform, congressional action is needed to reverse the trend toward balkaniza-

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181. D.C. CODE §§ 47-1580-80a (1961).

182. 380 U.S. at 561. (Justices Black and Douglas, both of whom had concurred in the *Northwestern* decision, dissented from this decision).

183. 380 U.S. at 561.

184. Hellerstein, *Unitary Business*, *supra* note 10, at 493.

185. 380 U.S. at 561.

186. *But cf.* *Ford Motor Co. v. Beauchamps*, 308 U.S. 331 (1939) (upholding a capital stock tax apportioned entirely upon the basis of gross receipts).

187. See Hellerstein, *State Taxation Under the Commerce Clause: An Historical Perspective*, 29 VAND. L. REV. 335, 350-51 (1976); *Developments in the Law*, *supra* note 37, at 1018-19.



tion of the national economy.<sup>188</sup>

The prospects for such congressional action looked good in 1959, when, in almost immediate response to the outcry of business in the aftermath of the *Northwestern* decision, Congress for the first time in its history enacted a general statute dealing with state taxation of interstate business. Public law 86-272<sup>189</sup> provided that no state shall tax a person engaged in interstate commerce, whose only connection with the taxing state consists of "solicitation of orders . . . for sales of tangible personal property . . . which orders are sent outside the State for approval or rejection."<sup>190</sup> More importantly in terms of the long run prospects of interstate taxation, the law also called upon the House Judiciary Committee to "make full and complete studies of all matters pertaining to the taxation by the States of income derived . . . from . . . interstate commerce . . . for the purpose of recommending to the Congress proposed legislation providing uniform standards in imposing income taxes on income so derived."<sup>191</sup>

A special subcommittee on interstate taxation was established and in 1964 the subcommittee published a report which outlined the problems with the interstate tax system at that time. The report concluded that "simplication in the multi-state tax system, through reduction of its multiplicity, variety, and mutability, is a necessary preliminary to achieving a reasonable level of compliance within tolerable cost levels."<sup>192</sup> The following year the subcommittee published an ambitious set of recommendations including the use of the two-factor property-

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188. See, e.g., Celler, *The Development of a Congressional Program Dealing with State Taxation of Interstate Commerce*, 36 *FORDHAM L. REV.* 385, 386-87 (1968); see also *Northwestern States Portland Cement Co. v. Minnesota*, 358 U.S. 450, 476-77 (1959) (Frankfurter, J. dissenting); cf. Hellerstein, *Interstate Business*, *supra* note 127, at 282-83 (calling for the creation of a federal agency to prescribe and administer uniform apportionment formulas).

189. Act of Sept. 14, 1959, Pub. L. No. 86-272, 73 Stat. 555.

190. *Id.* § 101(a). While it did not overrule the *Northwestern* decision, Public Law 86-272 did overrule two Louisiana decisions, which had held mere solicitation by salesmen who did not maintain any permanent physical establishment within the state was sufficient to create jurisdiction over a foreign corporation for tax purposes. See *Brown-Forman Distillers Corp. v. Collector of Revenue*, 234 La. 651, 101 So. 2d 70 (1958), *appeal dismissed*, 359 U.S. 28 (1959); *International Shoe Co. v. Fontenot*, 236 La. 279, 107 So. 2d 640 (1958), *cert. denied*, 359 U.S. 984 (1959).

191. Act of Sept. 14, 1959, Pub. L. No. 86-272, § 201, 73 Stat. 555. The results of this study have been cited extensively herein.

192. REP. 1480, *supra* note 4, at 384.

payroll formula as the sole method for dividing income among the states for tax purposes, without allowance for specific allocation of "nonbusiness" income or for separate accounting in special circumstances. The subcommittee also proposed that the Treasury Department and the federal courts resolve conflicts in some cases where various states assert inconsistent claims on a taxpayer's income.<sup>193</sup> A bill incorporating most of these recommendations was introduced into the House<sup>194</sup> and the "outcry of business and the States was spontaneous and in some instances explosive."<sup>195</sup> Subsequently, a new bill was introduced, eliminating the provisions relating to federal administration of state taxes and making the use of the two-factor formula optional with the taxpayer.<sup>196</sup> Although this bill was not considered by the full House during that term, similar bills providing for the two-factor formula were passed by the House of Representatives in both the Ninetieth and Ninety-First Congresses.<sup>197</sup>

There was strong opposition to the bills and the two-factor formula<sup>198</sup> and the Senate did not even consider an interstate taxation bill until the Ninety-Second Congress.<sup>199</sup> During the following congress, an interstate taxation bill was introduced in the Senate, which adopted the standard three-factor formula instead of the House two-factor formula.<sup>200</sup> As of this writing, Congress is still deadlocked. A house bill, which incorporates the two-factor property-payroll formula and a senate bill, employing the three-factor formula, have been introduced.<sup>201</sup> Con-

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193. SPECIAL SUBCOMM. ON STATE TAXATION OF INTERSTATE COMMERCE OF THE HOUSE COMM. ON THE JUDICIARY, STATE TAXATION OF INTERSTATE COMMERCE, H.R. REP. No. 952, 89th Cong., 1st Sess. 1144, 1162-63 (1965).

194. H.R. 11798, 89th Cong., 1st Sess. (1965).

195. Cahoon and Brown, *supra* note 41, at 188. See Hearings on H.R. 11798 Before the Special Subcomm. on State Taxation of Interstate Commerce of the House Comm. on the Judiciary, 89th Cong., 2d Sess., series 14 (1966); cf. Nemeth and Agee, *supra* note 33, at 250 (describing the hearings as a "dog and cat" fight).

196. H.R. 16491, 89th Cong., 2d Sess. (1966).

197. H.R. 2158, 90th Cong., 1st Sess. (1967) (passed May 22, 1968 by a vote of 284 to 89); H.R. 7906, 91st Cong., 1st Sess. (1969) (passed June 25, 1969 by a vote of 311 to 87).

198. See Keesling and Warren, *supra* note 17, at 163. In 1967, the California legislature passed a resolution opposing enactment of H.R. 2158 unless the states fail, after a reasonable time, to resolve the diversity problems on their own. Assembly J. Res. 25 (adopted July 27, 1967).

199. S. 317, 92nd Cong., 1st Sess. (1971).

200. S. 1245, 93rd Cong., 1st Sess. (1973).

201. H.R. 669, 95th Cong., 1st Sess. (1977); S. 2173, 95th Cong., 1st Sess. (1977).

gress appears to be waiting for state tax administrators and business concerns to reach a consensus before passing any comprehensive legislation in the area.<sup>202</sup>

In reaction to the perceived threat of federal intervention, the individual states, which had long been discounted as a source of impetus toward uniformity,<sup>203</sup> began showing signs of moving toward that goal. Although only two states had enacted the UDITPA at the time the house report was published, twenty-seven of the forty-six corporate income tax jurisdictions follow the UDITPA three-factor apportionment provisions as of this writing.<sup>204</sup> More importantly with respect to apportionment uniformity, thirty-eight of the corporate income tax states either statutorily prescribe the standard three-factor formula or make its use optional with the taxpayer.<sup>205</sup> However, since the federal uniformity bills have stalled in Congress, four states which had previously used the standard formula have changed their statutes to provide for use of a double-weight sales formula.<sup>206</sup>

#### IV. CONCLUSION

Interstate commerce and the taxation of out-of-state corporations are concerns of vital importance in our increasingly interdependent national economy. With the decline of separate

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202. See GLAZER, *supra* note 39, at 1004.

203. See, e.g., Hartman, *Multistate Business*, *supra* note 124, at 124-25; Hellerstein, *Interstate Business*, *supra* note 127, at 265.

204. Twenty-five states have passed and follow the UDITPA for apportionment of income. Two additional states, Missouri and Colorado, have adopted the Multistate Tax Compact, which includes the UDITPA in its provisions. [1977] STATE TAX GUIDE (CCH), at 1042-44. Although it follows the UDITPA for specific allocation of nonbusiness income, West Virginia is the only state in the union which prescribes the two-factor property-payroll formula. *Id.* at ¶ 10,925. Florida has also adopted the UDITPA, but has modified the apportionment provisions to double-weight the sales factor. See text accompanying notes 54-55, *supra*.

205. [1977] STATE TAX GUIDE (CCH) ¶¶ 10,203 - 10,943. This apparent uniformity may be misleading, however. To the extent that varying definitions of the sales factor are still used today, there exists a significant possibility of overtaxation. See text accompanying notes 47-53, *supra*. Secondly, as noted earlier, states differ greatly as to what income is to be specifically allocated and what income is to be subject to apportionment. See text accompanying notes 33-42, *supra*. Lastly, even among states which have adopted the UDITPA the implementation of the statute is not uniform. Utah, for example, still resorts to separate accounting when formulary apportionment would mean a serious loss of revenue to the state. See Cahoon and Brown, *supra* note 41, at 189.

206. See text accompanying notes 54-55, *supra*.

accounting and specific allocation, apportionment is rapidly becoming the predominant method for division of income among the states for tax purposes. Because of these trends, the need for a fair and uniform apportionment formula is becoming more immediate.

For those who advocate the inclusion of the sales factor in that formula, the application of the "source" test to the factor results, at best, in a confused stalemate. The benefits principle, on the other hand, seems most appropriate in the case of an income tax, which, by definition, is imposed only upon those with the immediate resources to pay it. It is argued that the consumer state, the state to which the sales factor apportions income, should be compensated for providing a market for the foreign manufacturer. However, most services provided by the market state, even those said to be involved with maintenance of the market, such as providing roads on which vehicles can be driven and maintaining a police force to protect goods from theft, offer little to the out-of-state producer. The direct benefits of such expenditures are enjoyed by the consumers located within the market state—those who escape taxation by the use of apportionment by sales.

The principal justification for the sales factor is, and has always been, that individual states have had the power to adopt it and have been unwilling to relinquish it. In recognition of this fact, the sales factor was included in the UDITPA formula and may well be included in the final version of a congressional bill. Experience has shown that in this area the states will continue to act in the interests of the national economy only when there is a perceived threat of imminent federal intervention. Thus, while the invalidation of the single-factor-sales formula in the *Moorman* case would be only a small step toward national uniformity, a failure to do so would constitute two giant steps backward in the area of interstate taxation.

THOMAS J. NICHOLS